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Significant Regulatory, Jurisdictional and Enforcement Challenges Ahead for CFTC

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In 2018, the Commodity Futures Trading Commission (CFTC or Commission) began operating with a full complement of five commissioners for the first time since 2014. Soon thereafter, it held a rare open meeting to propose major revisions to its rules for swaps trading. CFTC Chairman J. Christopher Giancarlo is the driving force behind this proposal, having long advocated for expanding swaps trading on self-regulating exchange-like platforms called swap execution facilities (SEFs). Whether Giancarlo will see his handiwork through to adoption is unclear, however, as he has announced he will be leaving the agency once his term expires in April 2019 and his successor is confirmed by the Senate. The White House already has announced its nominee to replace Giancarlo — Heath P. Tarbert, currently the assistant secretary for international markets at the Treasury Department.

Whoever is at the CFTC's helm in 2019 will face significant challenges. The European Union has indicated that it plans to adopt legislation that could subject U.S.-based clearinghouses to substantial EU oversight at a time when Giancarlo has been advocating for the exact opposite — full or at least greater deference to home-country regulators. As for enforcement, a series of court decisions has called into question some of the Commission's anti-manipulation and anti-fraud efforts. If those decisions remain the law, they will cut to the core of what must be pleaded under both the Commodity Exchange Act's (CEA) traditional anti-manipulation provisions and post-Dodd-Frank Act anti-manipulation and anti-fraud provisions.

Sweeping Amendments Proposed to SEF Rules

The CFTC proposed major changes to its swaps trading regime in November 2018, following a comprehensive white paper Giancarlo wrote urging the CFTC to revisit its 2013 swap rules. Those rules govern how swaps are traded on SEFs, which are CFTC-registered, exchange-type trading venues with self-regulatory obligations and powers. The CFTC's current SEF rules were adopted under the 2010 Dodd-Frank Act, which required the regulation of swaps trading by the CFTC for the first time. In his white paper, Giancarlo noted that all futures must by law be traded on exchanges, while swaps may be traded both on exchange-type platforms (such as SEFs) and, bilaterally, in private, over-the-counter negotiations. He urged the CFTC to revisit its swap rules to better recognize that swaps and futures are different.

In broad outline, the proposed amendments seek to increase swaps trading on SEFs — an unambiguous congressional goal — by (1) requiring additional entities to register as SEFs (including interdealer voice brokers); (2) relaxing the methods by which swaps may be traded and executed on SEFs; and (3) expanding the number and types of swaps that must be traded on SEFs.

The CFTC also proposes to allow a SEF to elect what types of market participants may access its markets. This change would enable a SEF to offer a dealer-to-dealer market and to exclude direct participation by the buy side (asset managers, proprietary trading firms and end users). Some have criticized these arrangements as giving dealers undue sway on swaps pricing.

Comments on the proposal are due February 13, 2019. Whether the final rules are adopted before Giancarlo's departure remains to be seen.

EU Derivatives Clearing Legislation

After the 2008 financial crisis, the G-20 championed increased clearing of financial derivatives contracts as a means of reducing systemic risk. The U.S. and EU, among others, responded by requiring more derivatives to be submitted for clearing and by enhancing regulatory scrutiny. While many observers consider these developments to be positive, the international nature of derivatives markets has left one substantial and thorny clearing issue to be settled: How should national regulators treat clearing providers, called central counterparties (CCPs), that offer clearing services to foreign market participants?

This question has become a highly contentious U.S.-EU battleground. In the U.S., the CFTC has taken various approaches to different markets. For exchange-traded derivatives, largely futures, it has long granted full deference to foreign regulators applying comparable regulations to foreign CCPs that clear transactions involving U.S. persons. But for swaps involving U.S. persons, the CFTC has been less deferential, subjecting at least some non-U.S. CCPs to CFTC regulation with respect to clearing for U.S. customers. The EU, by contrast, places exchange-traded and other derivatives into one basket and now is considering legislation to subject non-EU CCPs serving EU customers to considerable and aggressive EU regulation, including major U.S.-based CCPs.

Giancarlo has proposed mutual and even-handed deference in a white paper on cross-border swaps regulation. For instance, with respect to jurisdictions subject to comparable regulations, he has suggested expanding the CFTC's use of its authority to exempt from its requirements non-U.S. CCPs that do not pose substantial risk to the U.S. financial system. But the EU has thus far not changed course, making it increasingly likely that the EU legislation will be enacted in 2019. That prospect has spurred Giancarlo to warn that the CFTC will be forced to consider a "range of readily available steps" to respond in kind, including withdrawing existing exemptions for EU-based entities serving U.S. customers and delaying or withholding further regulatory relief.

As the clock ticks toward the EU's adoption of its proposed CCP legislation, the threat of trans-Atlantic market disruptions looms larger on the horizon. Between this clearing dispute and the risk of a hard Brexit, 2019 promises to be a momentous year.

CFTC Enforcement and CEA Private Litigation Developments

As outlined in its annual report, the CFTC's Division of Enforcement was busy in 2018 with 83 cases filed (third-highest in CFTC history); $900 million in penalties (fourth-highest); 26 cases alleging manipulation, spoofing or disruptive trading (annual average for 2009 to 2017 was six); and highest number and greatest amount of whistleblower awards (five awards totaling $75 million). Giancarlo has made clear that a vigorous enforcement program to protect market integrity remains a top priority for the CFTC, and the agency's 2018 enforcement record bears that out.

2018 CFTC Division of Enforcement

83
cases filed

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26
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5
whistleblower awards totaling $75 million

But 2019 could be more challenging for both the CFTC and private plaintiffs, based on recent and pending judicial decisions. *CFTC v. DRW* rejected the CFTC's attempt to expand its traditional price manipulation authority to cover instances where a trader merely intended to affect the price, even if there was another purpose for trading (such as hedging). Instead, the court reaffirmed that the

CFTC must prove a trader intended to create an artificial price — that is, a price that does not reflect the legitimate forces of supply and demand. Meanwhile, the U.S. Court of Appeals for the Second Circuit recently heard argument in an appeal of a decision that the CFTC claims could restrict the reach of its cross-border power to pursue price manipulation where the alleged misconduct occurs abroad. In *Prime International Trading, Ltd. v. BP Plc*, the district court held that the private plaintiffs' claims impermissibly required extraterritorial application of the CEA. The plaintiffs alleged that a number of companies involved in different sectors of the oil industry engaged in overseas manipulation of a foreign benchmark for the price of Brent crude oil that affected the prices of the plaintiffs' Brent crude oil futures and other derivatives contracts traded on the New York Mercantile Exchange and ICE Futures Europe.

The CFTC also faces challenges to its authority to sanction "manipulative or deceptive" schemes. One district court ruled in a pretrial proceeding that to do so, the CFTC must prove fraud and not just manipulative conduct (*CFTC v. Kraft Foods Group, Inc.*). That case may go to trial in 2019. In dismissing a CFTC action, another district court ruled that the converse is true: The CFTC must prove not just fraud but also manipulation (*CFTC v. Monex Credit Co.*). *Monex* is on appeal to the U.S. Court of Appeals for the Ninth Circuit. These decisions will go a long way toward shaping the scope of the CFTC's post-Dodd-Frank authority.

Lastly, private plaintiffs that seek to use the antitrust laws to bring claims against entities regulated by the CFTC could face a more difficult task. In a first-of-its-kind ruling under the CEA, a court rejected an antitrust claim against a CFTC-registered exchange on implied repeal grounds. That case, too, has been appealed, this time to the U.S. Court of Appeals for the Seventh Circuit.

Conclusion

The coming year promises to be pivotal for the CFTC: a change in leadership amid a significant swaps trading rule-making, EU legislation with serious ramifications for U.S. CCPs, and litigation by the Commission and private plaintiffs that could have a major impact on the CFTC's enforcement program. These developments warrant the attention of market participants.

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